CLOSED-END FUND

SPECIAL REPORT

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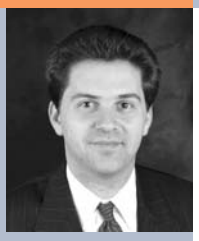

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Expect Minor Dividend Cuts From Muni CEFs in the Coming Months

With most municipal Closed-End Funds (CEFs) currently under-earning their distributions by a minor 2-5%, I think it is reasonable to expect minor distribution cuts over the next several months, starting as early as June 1st. Bear in mind that while, on average, municipal CEFs are slightly under-earning their monthly distributions, they also have roughly two months' worth of undistributed net investment income (UNII) on their balance sheets. I believe this should keep most of the cuts in the "minor" range of 2-5%. Funds which have built up these large UNII balances could elect to tap these balances now to maintain distributions or elect to lower their distributions to keep earnings more in line with distributions. Either way, I expect most of the cuts to be very minor and not much more significant than we saw earlier this year. The reasons I believe there may be potential distribution cuts are fairly straightforward and are outlined below:

Bond Calls: Just as individual investors are dealing with 5% and 6% coupon bond calls, so too are municipal CEF investors. When these higher yielding bonds are called they are being replaced with lower yielding ones, which negatively impacts the earnings of a fund.

Higher Leverage Cost: After the auction rate preferred (ARP) market collapsed in February of 2008, some muni CEFs elected to lock in their borrowing cost for five years at a higher interest rate of roughly 2.5%. This should help these funds when short-term interest rates move up. However, it is less helpful to them now as short-term interest rates and short-term borrowing cost remain low for funds which still borrow at short-term rates. It is mostly the funds that have locked in their borrowing cost that are under-earning their distributions, as opposed to the funds that continue to primarily borrow at floating, short-term interest rates.

It is important to keep several things in mind when considering these potential cuts:

1. I believe these cuts will mostly be minor cuts in the 2-5% range.
2. The average national leveraged muni CEF yields currently 6.03% and, even if every national muni CEF cut its distribution by 5%, the average yield would still be roughly 5.70%, which is still a very attractive yield in this environment.
3. While I do think it is prudent for investors to expect more share price volatility in muni CEFs this year, there are many positive factors that I believe will likely continue to trump any potentially minor cuts. They include very strong technical factors for muni bonds and muni CEFs (i.e. less supply of muni bonds and very high demand for high quality muni bonds and muni cefs), concern about higher taxes, very compelling after-tax yields of roughly 8-9%, low default rates and the demand for high quality, safe haven assets during volatile markets.
4. Municipal CEFs are trading at or near their all-time highs as measured by the First Trust Municipal Closed-End Fund Price Index (MNCEF) and are again benefiting from all the positive factors listed above. According to Morningstar, the average muni CEF is up 7.04% YTD on a share price total return basis through 5/31/12.

I continue to advocate CEF investors primarily maintain a three-pronged, balanced approach to investing in CEFs this year. (See Special Report: Still Advocating a Balanced, Three-Pronged Approach to Investing in CEFs, June 1, 2012.)

The three prongs include:

1. Domestic equity CEFs
2. Credit sensitive CEFs
3. High credit quality Municipal CEFs

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